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Before The  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

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JUN 29 1994

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In the Matter of

Implementation of Sections of the  
Cable Television Consumer Protection  
and Competition Act of 1992

Rate Regulation

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)  
) MM Docket No. 92-266  
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)

COMMENTS OF LIBERTY MEDIA CORPORATION

Robert L. Hoegle  
Timothy J. Fitzgibbon  
Carter, Ledyard & Milburn  
1350 I Street, N.W., Suite 870  
Washington, D.C. 20005  
(202) 898-1515

Attorneys for  
Liberty Media Corporation

June 29, 1994

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## TABLE OF CONTENTS

Summary . . . . .	ii
Introduction . . . . .	1
I. The Current Going Forward Rules Provide Inadequate Incentives For Adding Programming And Require Substantial Modification . . . . .	3
A. The Percentage Mark-Up On Programming Costs Is Inadequate And May Distort Carriage Decisions . . . . .	5
B. The Residual Component Adjustment Does Not Permit Recovery Of Non-External Costs, Much Less A Reasonable Return On Them . . . . .	7
II. Appropriate Going Forward Rules Should Balance Other Public Policy Objectives Identified By Congress In The 1992 Cable Act . . . . .	9
III. The Commission's Going Forward Rules Also Should Reflect Potential Revenues From Alternative Channel Uses And Historical Price Increases For Added Channels . . . . .	12
A. Going Forward Rules Should Account For The Potential Revenues Available From Alternative Uses Of Channel Capacity . . . . .	12
B. In Revising Its Going Forward Rules, The Commission Should Consider Historical Price Increases For Added Channels . . . . .	14
IV. The Commission Should Modify Other Regulations Discouraging The Addition Of New Programming Services To Regulated Tiers . . . . .	16
Conclusion . . . . .	18

## SUMMARY

The Commission should modify its going forward rules to establish reasonable incentives for cable operators to add new services to regulated tiers without tilting carriage decisions in favor of high or low cost services. The current incentives -- which consist of a 7.5 percent mark-up on the cost of the new programming services, plus an "adjustment" of the "residual component" amounting in most cases to 2 cents or less -- are inadequate and have created "gridlock" in the programming marketplace.

The 7.5 percent mark-up on programming costs under the current rules provides little incentive to expand regulated services and, if anything, encourages carriage of high-cost services on regulated tiers. Instead, to minimize any bias against low-cost services, the Commission should consider going forward rules which permit recovery of new programming costs plus a reasonable fixed amount for each new service added.

The current "adjustment" of the residual component clearly is insufficient to cover the non-programming costs involved in adding new programming services to regulated tiers, much less to provide an incentive for expanding service offerings. The Commission acknowledges that, although it is intended to permit recovery of "non-external" costs, the adjustment table contained in Section 76.922(e) is not based on the actual cost of adding new services. Although such costs may vary widely on a per-subscriber basis, they clearly will exceed the current residual component adjustment.

Liberty Media respectfully suggests that the current going forward rules have failed in large part because they focus exclusively on costs and the preservation of reduced cable rates for subscribers. However, rate reduction was not the sole objective of the 1992 Cable Act. Consequently, appropriate going forward rules must incorporate other public interest objectives identified by Congress.

In establishing the appropriate amount of such fixed per-channel increases, the Commission should consider factors other than the costs incurred to add new services. For example, the Commission should consider the potential revenue available to cable operators through alternative uses of channel capacity, including the addition of a-la-carte, premium or pay-per-view services. The Commission also should consider the historical changes in rates over time as new services were added to systems. Liberty Media believes that such non-cost considerations would be taken into account by "competitive" cable systems in making similar carriage decisions and rate adjustments and would justify substantially greater incentives than those available under the current going forward rules.

Finally, in addition to enhancing the financial incentives for adding channels to regulated services, the Commission should modify or eliminate other rules which substantially discourage new service offerings on regulated tiers.

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COMMENTS OF LIBERTY MEDIA CORPORATION

Liberty Media Corporation ("Liberty Media") submits these comments in response to the Commission's Fifth Notice of Proposed Rulemaking in this proceeding.<sup>1</sup> The Commission should modify substantially the "going forward methodology" adopted in the Fourth Report in order to provide sufficient incentives for cable operators to add new programming services to regulated tiers without tilting carriage decisions in favor of lower or higher cost programming services.

Introduction

The "going forward" rules adopted by the Commission in the Fourth Report govern the adjustment of regulated cable rates when new programming services are added to basic or other regulated cable service tiers. Because those rules

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<sup>1</sup> See, Second Order on Reconsideration, Fourth Report and Order and Fifth Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 94-38 (rel. Mar. 30, 1994) ("Second Order," "Fourth Report," and "Fifth Notice," respectively).

provide the financial basis for future carriage decisions by cable operators, they directly and substantially affect the quantity, quality and diversity of programming available to consumers. Thus, in addition to establishing the methodology for adjusting regulated cable rates, the going forward rules represent the primary means of furthering the Congressional objectives of "promot[ing] the availability to the public of a diversity of views and information through cable television" and "ensur[ing] that cable operators continue to expand, where economically justified, their capacity and the programs offered over their cable systems." See Cable Television Consumer Protection and Competition Act of 1992 ("1992 Cable Act"), §§2(b)(1), (3).

Liberty Media has a direct and substantial interest in the adoption of appropriate going forward rules. It holds interests in a number of existing satellite broadcast and/or satellite cable programming services and continues to develop new programming ventures. Liberty Media's existing and prospective programming services range from relatively low-cost national services to higher-cost regional sports services. Future carriage decisions by cable operators regarding these and other programming services should be based on the relative merits and potential audience appeal of the programming rather than blind application of regulatory rate adjustment mechanisms. Consequently, Liberty Media respectfully suggests that any modification of the current going forward rules in this

proceeding should: (a) provide adequate financial incentives for cable operators to expand regulated service tiers rather than to carry new services exclusively on an unregulated a-la-carte basis; (b) establish a balanced framework for future carriage decisions favoring neither low nor high cost services; and (c) increase the diversity of programming available to consumers and promote the continuation and growth of locally originated programming.

I. The Current Going Forward Rules Provide Inadequate Incentives For Adding Programming And Require Substantial Modification.

In its Fourth Report in this proceeding, the Commission adopted rules governing the adjustment of regulated cable rates when new programming services are added to regulated service tiers. The rate for a regulated tier may be increased when a new service is added to that tier by an amount equal to: (a) an adjusted "residual component" which, for systems with 36 or more regulated channels, is 2 cents or less per added channel; (b) the programming expense for the added service; and (c) a 7.5 percent "mark-up" on that new programming expense. Fourth Report at ¶¶246-47. Thus, under the current going forward rules, the total incentive for a cable operator to add new programming to regulated tiers consists of a 7.5 percent "mark-up" on the cost of the new service, plus an "adjustment" of 2 cents or less on the residual component.

Since the Commission adopted these rules, the marketplace has confirmed that such "incentives" are insufficient to induce cable operators to add new programming services to regulated tiers. Cable operators, programmers and even public interest groups have uniformly criticized the rate adjustment mechanism as insufficient to motivate cable operators to expand regulated service offerings. See, e.g., Petition for Reconsideration of Viacom International Inc., filed May 16, 1994, at 2-7; Petition for Clarification or Partial Reconsideration of the Commissioner of Baseball, filed May 16, 1994, at 1-2; Comments of Programming Providers ("Ovation/PBS Comments"), filed May 16, 1994, at 8-22; Petition for Expedited Reconsideration of Public Interest Petitioners ("Public Interest Petition"), filed May 16, 1994, at 8-11, 14-16. In addition, numerous new programming services scheduled for launch this year have announced substantial launch delays or cancellations since the going forward rules were adopted. See, e.g., Mitchell & Granger, "Operators Give New Networks Little Attention," Multichannel News, Mar. 7, 1994, at 3; Breznick, "Network Wannabes Press On Despite Dour Launch Outlook," Cable World, Apr. 11, 1994, at 1, 50; Higgins & Granger, "Small Nets, Big Problem?," Multichannel News, Apr. 25, 1994, at 1, 54. In short, the current going forward rules must be modified because they have created "gridlock" in the marketplace for new basic and other cable programming services.



A. The Percentage Mark-Up On Programming Costs Is Inadequate And May Distort Carriage Decisions.

Under the current going forward rules, the primary incentive for a cable operator to add new programming services to a regulated tier is a 7.5 percent "mark-up" on the cost of those services. Fourth Report at ¶246. This mark-up not only provides an insufficient incentive to expand regulated tiers, but also may encourage cable operators to make carriage decisions for regulated tiers based on the cost of a new programming service rather than its potential audience appeal.

The current 7.5 percent mark-up generally provides insufficient incentive to add new programming services to regulated tiers, regardless of the cost of those services. See, e.g., Opposition of Discovery Communications, Inc., filed June 16, 1994, at 3-5; Cox Cable Communications, Inc. and Newhouse Broadcasting Company, "Adding Channels: A Proposed Approach for Restoring Incentives to Carry New Programming Services" ("Adding Channels: A Proposed Approach"), May 31, 1994, at 10-12. The Commission's own rules also create strong incentives for cable operators to invest in anything but new programming services. For example, a dollar invested by a cable operator in plant or equipment brings a regulated rate of return of 11.25 percent under the Commission's cost-of-service rules, but only a 7.5 percent return if invested in programming appearing on a regulated service tier. See

Fourth Report at ¶246 n.345.<sup>2</sup> Under these circumstances, the 7.5 percent mark-up is inadequate to spur carriage of new programming services on regulated tiers.

Moreover, the Commission has recognized in other contexts that rate of return regulation may create improper incentives. See, e.g., Policy and Rules Concerning Rates For Dominant Carriers, 4 FCC Rcd. 2873 (1989), at ¶7, on recon., 6 FCC Rcd. 665 (1991) (rate of return regulation "does not encourage the kinds of economically efficient behavior...that result in cost savings, product innovations, and, ultimately, lower rates for consumers," and "is particularly counterproductive when applied in markets characterized by emerging competition"). In the context of carriage decisions by cable operators, the "mark-up" on the cost of newly-added services arguably creates an incentive to sacrifice editorial judgment in favor of the greater financial returns provided by high-cost programming services, regardless of their audience appeal. As several parties have recognized, the 7.5 percent mark-up provides no incentive to add low-cost services or services which charge no license fee to the cable operator. See, e.g., Petition for Reconsideration of Eternal Word Television Network, filed May 16, 1994, at 2-4; Comments of the

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<sup>2</sup> The only explanation for the disparity between the "reasonable rate of return" for investment in "tangible plant" and the permitted "mark-up" on new programming services is the Commission's "belief" that the latter "should be less than" the former. Fourth Report at ¶246 n.345.

Times Mirror Company, filed May 16, 1994, at 3-6; Ovation/PBS Comments at 8-13.

In short, the 7.5 percent mark-up provides little incentive for cable operators to expand regulated service tiers and may skew carriage decisions against lower-cost programming services. Liberty Media respectfully suggests that going forward rules which permit recovery of new programming costs, plus a reasonable fixed amount for each new service added to a regulated tier, may help to minimize any bias against low-cost services embodied in the current rules. However, the Commission also should recognize that, by yielding a lower margin on higher-cost services, even a fixed increase may bias carriage decisions. See Adding Channels: A Proposed Approach at 16 ("Under a fixed mark-up approach, there may be incentives to add services that cost the operator very little and disincentives to add more expensive services").

B. The Residual Component Adjustment Does Not Permit Recovery Of Non-External Costs, Much Less A Reasonable Return On Them.

Other than the percentage mark-up on new programming costs, the only incentive to add new programming services to regulated tiers under the current rules is the upward "adjustment" of the residual component pursuant to Section 76.922(e). Although the "adjustment" to the residual component calculated by the Commission apparently was intended to permit recovery of, and a reasonable return on, the "non-programming" or "non-

external" costs to add a new programming service to a regulated tier, the Commission has acknowledged that its table of adjustments is not based on any cost information from cable operators. See Fourth Report, Technical Appendix at 25. Instead, the "non-external cost recovery formula" developed by the Commission is "based...on our benchmark rate equation," which was derived from reported per-subscriber revenues for systems with different numbers of channels on tiered services. Consequently, the adjustment table has little to do with the actual cost of adding a new programming service.<sup>3</sup>

The current "adjustment" of the residual component plainly is insufficient to recover the non-programming costs of adding a new service to a regulated tier, much less to earn a return on those costs. Clearly, adding a new service to a regulated tier using the residual component adjustment is a losing proposition. For example, it would take a cable operator a year or two just to recover the cost of the postage stamp if it provided the notice required by Section 76.932 to each subscriber by mail.

Of course, when adding a new service, a cable operator incurs costs in addition to those for such subscriber notification. Among other things, the cable operator incurs

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<sup>3</sup> In addition, the resulting adjustment table does not differentiate between services added to the basic tier, for which costs are spread among all subscribers, and services added to other tiers which do not achieve 100 percent penetration. Id. at 26-28 and n.68.

costs for: marketing (to determine subscriber interest in new services and to promote them); legal (to negotiate a carriage agreement); engineering (to install equipment and to receive and distribute the signal); regulatory compliance (to file the required FCC Form(s)); and equipment. A cable system rebuild or upgrade would drastically increase the cost of adding channels. Although these costs may vary widely on a per-subscriber basis, depending upon the expenses incurred and the number of subscribers, they clearly will exceed the present residual component adjustment. Unfortunately, this "adjustment" is the only means of obtaining any return under the current rules when low-cost services, or services which do not charge a license fee, are added to regulated tiers.

II. Appropriate Going Forward Rules Should Balance Other Public Policy Objectives Identified By Congress In The 1992 Cable Act.

In its First Order on Reconsideration, Second Rate Order, and Third Notice of Proposed Rulemaking in this proceeding, 9 FCC Rcd. 1164 (1993) ("Third Notice"), the Commission stated that the "appropriate methodology" for adjusting regulated cable rates when channels are added to a regulated service tier "should provide sufficient incentives for cable operators to invest in continued growth of cable television service while not permitting operators to raise rates to unreasonable levels." Third Notice at ¶136. Although Liberty Media never questioned that objective, it expressed concern

that over-emphasis on rate reduction in formulating the going forward rules might undermine other Congressional objectives, including the promotion of increased programming diversity and the continuation and growth of local origination programming. See Liberty Media Comments, filed Sept. 30, 1993, at 1-3.

Nevertheless, the Fourth Report confirms that the overriding objective of the current going forward rules is the establishment and maintenance of lower cable rates for consumers:

[O]ur methodology for adjusting capped rates when channels are added or deleted from regulated tiers should be consistent with, and further implement, our general approach for regulation of cable service rates. Thus, our regulations governing adjustments to capped rates should preserve the competitive rates produced by our requirements for setting initial regulated rates, since rates closer to competitive levels will best serve consumers.

Fourth Report at ¶237. The Commission apparently believed that increased diversity and local origination of programming would flow naturally from going forward rules which preserved lower cable rates because "lower rates for goods and services can in many cases increase the quantities demanded and can further increase output." Id. Consequently, the Commission reasoned that the public ultimately would benefit from going forward rules which placed primary emphasis on preserving reduced cable rates because consumers eventually would receive "a greater quantity and range of services at lower prices." Id.

Unfortunately, it is unlikely that the Commission's expectations will materialize in the marketplace under the current incentives. The going forward rules may preserve "lower prices" for consumers, but they will not result in "a greater quantity and range of services" for viewers. Instead, the rules unquestionably will limit the variety of viewing choices available to consumers, particularly on regulated tiers, contrary to several of the policy objectives identified by Congress in the 1992 Cable Act.

Liberty Media respectfully submits that appropriate going forward rules must balance the objective of lower subscriber rates with other important public interest objectives. Congress gave no indication that its objectives of promoting diversity and "ensur[ing] that cable operators continue to expand...the programs offered over their cable systems" should take a back seat to "lowering subscriber rates." See 1992 Cable Act, §2(b); Public Interest Petition at 6-13. These other Congressional objectives deserve equal consideration by the Commission in developing appropriate going forward rules.<sup>4</sup>

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<sup>4</sup> For example, in enacting the must-carry and retransmission consent provisions of the 1992 Cable Act, Congress purported to balance its objective of ensuring the continued "local origination of programming" with maintaining reasonable rates for basic cable service. See 1992 Cable Act, §2(a)(10)-(11); H.R. Conf. Rep. No. 862, 102d Cong., 2d Sess. 76 (1992).

**III. The Commission's Going Forward Rules Also Should Reflect Potential Revenues From Alternative Channel Uses And Historical Price Increases For Added Channels.**

The current going forward rules clearly "stack the deck" against carriage of new programming services, particularly low-cost services, on regulated tiers. In order to minimize the disincentive to expand regulated service offerings, without encouraging or discouraging tiered carriage, the Commission should revise its going forward rules to establish financial incentives which are not based exclusively upon the cost to the cable operator of adding new services. Consistent with the Congressional objectives set forth above, the Commission also should consider the revenues which cable operators may obtain from alternative uses of channels and historical price increases when channels were added.

**A. Going Forward Rules Should Account For The Potential Revenues Available From Alternative Uses Of Channel Capacity.**

Even if a cable operator could be assured recovery of all programming and non-programming costs plus a fixed per-channel increase for each new service added, there still may be a disincentive to adding new programming services to regulated tiers. Going forward rules which permit only de minimis per-channel increases over and above new programming costs will not promote carriage of new services on regulated tiers if the cable operator can realize substantially greater net



revenues through a-la-carte carriage of those services or readily available alternatives.

At least one industry analysis suggests that a cable operator is most likely to maximize revenues by adding a-la-carte or mini-pay services rather than expanding regulated service tiers. See Paul Kagan Associates, Inc., Cable TV Programming, Feb. 28, 1994, at 1-3.<sup>5</sup> Although basic carriage ensures distribution to all subscribers, the low per-subscriber return resulting from the percentage mark-up under the current rules yields a net revenue increase substantially lower than a modestly successful a-la-carte service. For example, a cable operator with 5,000 basic subscribers which adds a service with a license fee of 10 cents per subscriber will realize additional monthly revenues (net of programming costs) of only \$137.50, assuming that it receives a 2 cent "adjustment" to its residual rate component. However, if the cable operator adds an a-la-carte service with a 40 cent fee to subscribers and the same programming cost, it could realize the same increase in net monthly revenues with less than a 10 percent penetration rate.

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<sup>5</sup> The Kagan analysis calculated estimated incremental revenues per channel for programming services on regulated basic, a-la-carte tier, mini-pay service, and pay-per-view channel. The analysis presumed certain rates, programming costs and penetration levels. Based on the presumed variables, the analysis calculated potential revenues per subscriber for these alternative uses of channel capacity.

The current going forward rules, therefore, may skew carriage decisions in favor of a-la-carte carriage, particularly for low-cost services. In determining the appropriate amount of any rate increase to account for the addition of new services, the Commission must consider factors other than the programming and "non-external" costs incurred in adding the new service to a regulated tier. The Commission's going forward rules should afford cable operators adding new services on regulated tiers returns reasonably commensurate with those readily available through unregulated carriage of other available services.

B. In Revising Its Going Forward Rules,  
The Commission Should Consider Historical  
Price Increases For Added Channels.

Although based on rate information, the residual component adjustment was not derived from any actual rate increases resulting from the addition of new programming services. Clearly, the Commission did not examine changes in the rates for tiered services as new channels were added over time. See Fourth Report, Technical Appendix at 25-26. Instead, the Commission's adjustment formula "mistakenly equated the observed difference in rates between systems with different numbers of channels with the reduction in per-channel rates that a particular system would have implemented had it increased the number of channels of programming on its system." Adding Channels: A Proposed Approach at 13.

Thus, the Commission's calculations measure only price differences for systems with different numbers of channels and do not accurately reflect price changes attributable to newly-added channels. Liberty Media respectfully suggests that a more appropriate analysis would examine the historical changes in rates over time as new programming services were added to particular systems. See Adding Channels: A Proposed Approach at 13. Liberty Media believes that such an analysis would support substantially higher incentives than those afforded under the current going forward rules.

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Therefore, Liberty Media respectfully suggests that the Commission revise its "going forward" regulations to provide realistic incentives to cable operators for adding new channels to regulated tiers. Such incentives should not favor tiered over a-la-carte carriage but should take into account the revenues which cable operators may obtain from alternative uses of channel capacity, thereby facilitating more balanced carriage decisions by cable operators. Further, the Commission should consider the available data regarding historical price increases for additional channels.

Liberty Media believes that such additional considerations will support a substantially higher and "fixed" per-channel increase, plus the cost of new programming services, as an appropriate incentive for added channels. Other

programmers have suggested that a reasonable fixed incentive is appropriate and consistent with their industry experiences. See Ovation/PBS Comments at 12-13; Comments of A&E and ESPN in Support of Petitions for Reconsideration, June 16, 1994, at 9.

IV. The Commission Should Modify Other Regulations Discouraging The Addition Of New Programming Services To Regulated Tiers.

The potential financial benefit to cable operators under the existing "going forward" rules is simply insufficient to overcome the cumulative effect of other rule provisions which substantially discourage carriage of new programming services on regulated service tiers. For example, a cable operator whose existing rate structure has not been challenged within the required time frame, subjects itself to new complaints challenging its existing rate structure for a 45 day period simply by adding a new programming service to a regulated service tier and adjusting rates accordingly. See 47 C.F.R. §76.953(b). Obviously, this provides a significant disincentive to add any new service and change regulated rates.

Other regulations further discourage cable operators from adding new services to the basic service tier. For example, local franchising authorities may delay rate increases resulting from the expansion of basic programming services for up to four months for benchmark regulated systems and six months for systems submitting cost-of-service show-

ings. See 47 C.F.R. §76.933(b). Moreover, if the franchising authority does nothing within that time period and the cable operator implements the rate increase to account for the added basic services, it may be subject to refund liability if the franchising authority subsequently denies the rate increase. See 47 C.F.R. §76.933(c). Thus, a cable operator adding new services to the basic tier faces the prospect of significant delays and uncertainty in recovering the cost of providing additional services. Consequently, in addition to enhancing the incentives contained in the going forward rules, the Commission should modify or eliminate the other rules which significantly discourage expansion of basic and other regulated service tiers.

Finally, the Commission should recognize that its solicitation of further comment on the going forward rules in the Fifth Notice has had the unintended consequence of making it even more difficult for programming services to obtain carriage on regulated service tiers. The few cable operators inclined to add programming services to basic or other regulated tiers naturally will await the outcome of this proceeding to see if the new rules will provide enhanced financial incentives to add such services. In order to remedy this stalemate in the near term, the Commission should announce that cable operators adding new services after the effective date of the Fourth Report will be entitled to receive the

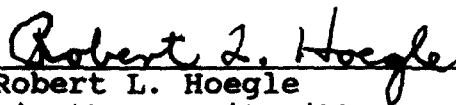
benefit of any enhanced incentives created through modification of the going forward rules in this proceeding.

### Conclusion

The Commission should substantially modify its going forward rules to achieve the policy objectives identified by Congress in the 1992 Cable Act. The current rules based on a percentage mark-up on new programming costs and the residual component adjustment simply will not work. In revising its going forward rules to provide a realistic fixed per-channel incentive for adding channels, the Commission should consider both the potential revenues from alternative uses of channel capacity and historical price changes for added channels. Finally, the Commission should modify other rule provisions which discourage adding new services to regulated tiers.

June 29, 1994

Respectfully submitted,

  
Robert L. Hoegle  
Timothy J. Fitzgibbon  
Carter, Ledyard & Milburn  
1350 I Street, N.W., Suite 870  
Washington, D.C. 20005  
(202) 898-1515

Attorneys for  
Liberty Media Corporation